No. 1

In the

Supreme Court of the United States

October Term, 1939

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner

v.

Wilshire Oil Company, Inc.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit

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BRIEF FOR RESPONDENT

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No. 1

In the

Supreme Court of the United States

OCTOBER TERM, 1939

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WILSHIRE OIL COMPANY, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR RESPONDENT*

Opinions Below

The opinion of the Board of Tax Appeals [R. 54-56] is reported in 35 B.T.A. 450. The opinion and dissenting opinion in the Circuit Court of Appeals [R. 72-80] are reported in 95 F. (2d) 971.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered April 1, 1938 [R. 79]. The petition for a writ of certiorari was filed June 30, 1938, and was

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*Italics supplied throughout unless otherwise indicated.

granted April 3, 1939 [R. 82]. The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented

Section 114 (b) (3) of the Revenue Act of 1928 allows an arbitrary deduction for depletion of oil and gas property in the amount of 27½% of the gross income *from the property* during the taxable year, but provides that the "allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) *from the property*".

In taxpayer's return for the year 1925 it deducted its development expenditures in computing its *taxable* net income [R. 53]. By so doing it became irrevocably bound, under Art. 223 of Regs. 69 and Art. 243 of Regs. 74, to do likewise in its returns "for all subsequent years," including the taxable years 1929 and 1930 here involved. At the time the taxpayer's 1925 return was filed, it had been the consistent administrative practice since the question first arose in 1921 not to require development expenditures to be deducted in determining "net income *from the property*" for the purpose of the *limitation* on the depletion deduction, regardless of whether the taxpayer elected

to capitalize them or to deduct them in computing *taxable* net income. This administrative practice had been approved by Congress in enacting the Revenue Acts of 1924, 1926 and 1928.

The *first* official attempt to change the settled meaning of "net income from the property"—by Art. 221 (i) of Regs. 74—occurred in February, 1929, nine months subsequent to the approval of the statute here involved. This was three years after the binding election made by the taxpayer in its 1925 return, and the Commissioner never has released the taxpayer from its agreement to deduct development expenditures in computing *taxable* net income "for all subsequent years."

Thus the *true question* may be fairly stated as follows:

May the Commissioner, by a regulation promulgated for the first time subsequent to the approval of the applicable Revenue Act of 1928, interpret the term "net income * * * from the property", as used in *that* statute, in a manner diametrically opposed to the consistent construction of *identical* language in the Acts of 1921, 1924 and 1926, specifically approved by Congress, especially when the Commissioner refuses to release the taxpayer from the permanently binding effect of an election made in its return for 1925 on the faith of the established and consistent prior construction?

Statute and Regulations Involved

The statute and regulations involved, as set forth in Appendix A of the Commissioner's brief, are incomplete in important respects, particularly in the *omission* of the following sentence which appears in Art. 243 of Regs. 74:

> "* * * An election once made under this option will control the taxpayer's returns for all subsequent years. * * *"

By reference to page 5 of the Commissioner's petition for certiorari, it will be observed that this vitally important sentence was not omitted there.

Art. 223 of Regs. 69 under the 1926 Act contained language identical with that quoted above.

The statutes and regulations which the taxpayer conceives to be involved are are follows:

Revenue Act of 1928, c. 852, 45 Stat. 791:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * * * * *
>
> (1) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *
>
> (For percentage depletion in case of oil and gas wells, see section 114 (b) (3).)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * * * * *

(b) *Basis for depletion.*—

* * * * * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Treasury Regulations 74, promulgated February 15, 1929 under the Revenue Act of 1928:

ART. 221. *Depletion of mines, oil and gas wells; depreciation of improvements.*—

* * * * * * * *

(i) "Depletion" allowance based on the income from oil and gas wells": The deduction for depletion based on the income from oil and gas wells shall not exceed 50 percent of the net income of the taxpayer, computed without allowance for depletion, from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference

to the income from the property. The phrase "net income of the taxpayer (computed without allowance for depletion)" means the gross income from the sale of oil and gas less the deductions in respect to the property upon which depletion is claimed, including overhead and operating expenses, development expenses (if the taxpayer has elected to deduct development expenses), depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. * * *

* * * * * * * *

ART. 243. *Charges to capital and to expense in the case of oil and gas wells.*—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. * * * *An election once made under this article will control the taxpayer's returns for all subsequent years.*

Treasury Regulations 69, promulgated August 28, 1926, under the Revenue Act of 1926:

ART. 223—Identical with Art. 243, Regs. 74, *supra.*

Statement

Respondent admits, as asserted in petitioner's brief, p. 3, that in its returns for 1929 and 1930, it deducted, in computing *taxable* net income, development expenditures in the respective amounts of $606,051.66 and $279,927.04. But the respondent had no free choice in this respect—it was *required* to deduct these amounts because, by electing, in its 1925 return, to deduct items of the same character, respondent had in effect entered into a contract[1] with the Commissioner that it would continue that practice "for all subsequent years." [R. 53; Art. 223, Regs. 69.]

Respondent admits that the Commissioner ruled that no depletion could be allowed under the 27½ percent provision, but denies the assertion of the first sentence of footnote 3, p. 5; the record shows that the Commissioner allowed no depletion deduction *whatever* in computing the deficiencies for 1930 [R. 52, last line].

The taxpayer is not claiming, in the case of any of its oil properties, a depletion allowance in excess of the statutory 27½% of the gross income therefrom. Its sole claim is that the Commissioner is not justified in *cutting down* the 27½% allowance by taking into account the taxpayer's development expenditures.

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[1]As to element of contract, compare *Ilfeld Co. v. Hernandez*, 292 U. S. 62, 65, where this Court said: "The making of the consolidated return constituted *acceptance* * * * of the regulations that had been prescribed."

Summary of Argument

The meaning of the applicable statute—the Revenue Act of 1928—should be ascertained as of May 29, 1928, the date of its approval. The phrase here involved, "net income from the property," originated in the Revenue Act of 1921 as a *limitation* on discovery depletion. It was then construed by the Treasury, as the Commissioner concedes, in a manner favorable to the taxpayer's contentions here. It was reenacted in the Revenue Act of 1924 after the Treasury's construction, which was a reasonable one, had been brought to the attention of Congress and approved. Although the Revenue Act of 1926 substituted percentage depletion for discovery depletion, the identical *limiting* formula of 50% of the "net income from the property" was "retained," as the Congressional Committee reports show. That the Treasury considered the Act of 1926 required no change in the meaning of "net income from the property" is shown by the fact that it made no change in Regs. 69, promulgated under that statute; and by the further fact that Treasury Decision 4025, issued in June, 1927, made no reference to any projected change. Art. 221 (i) of Regs. 74, here involved, was not published until 1929, nine months after the approval of the Act of 1928. The Commissioner admits that this was the "first official" attempt, approved by the Secretary of the Treasury, diametrically to change, by regulation, the meaning which had been consistently

given to *identical* language in the Acts of 1921, 1924 and 1926. The only judicial construction of "net income from the property," as used in prior Acts, is found in *Ambassador Petroleum Co. v. Commissioner*, 81 F. (2d) 474 (C.C.A.-9th), and is in favor of the taxpayer.

In its tax return for 1925 respondent elected to deduct development costs in determining *taxable* net income. It thereby accepted the condition of Regulations 69 that it must do likewise "for all subsequent years." This election was made long before Regulations 74 were issued and on the faith of the original and consistent Treasury practice that it would not have to deduct such costs in determining "net income from the property." For the Commissioner to attempt to withdraw one of the inducements to the election, while holding taxpayer to the burdens, is highly unreasonable and grossly inequitable. In such circumstances at least, the Treasury has no power to change the plain and settled meaning of statutory language.

Under the reasoning of *Helvering v. Reynolds Tobacco Co.*, 306 U. S. 110, the enactment of the Act of 1932 and subsequent revenue statutes does not amount to sanction of retroactive enforcement of the 1929 regulation, in the teeth of the former regulations which received Congressional approval, by the passage of successive Revenue Acts, including that of 1928.

ARGUMENT.

I. The Administrative and Legislative History of Prior Revenue Acts Clearly Shows the Invalidity of the Change Made by the Commissioner in Regulations 74.

The Revenue Act of 1928, here involved, was approved May 29, 1928. What did Congress, *on that date*, mean by "net income * * * from the property"? The answer must be sought, it is submitted, from a consideration of the meaning assigned by the Treasury Department and by Congress to *identical* language in *prior* revenue acts.

The phrase in question *originated* in Section 234 (a) (9) of the Revenue Act of 1921. It was reenacted *without change* in Section 204 (c) of the 1924 Act, in Section 204 (c) (2) of the 1926 Act, and in Section 114 (b) (3) of the 1928 Act.

Granting *arguendo* that the phrase was ambiguous when *first* used in 1921, and conceding also that Congress, *at that time*, intended that the Commissioner, "in order to effectuate the legislative intent", should exercise "wide discretion in respect of" its interpretation and application (*cf. Burnet v. S. & L. Bldg. Corp.*, 288 U. S. 406), it is conceded by the Commissioner that the Treasury gave the very question here involved thorough consideration "Shortly after the enactment of the Revenue Act of 1921," and reached the decision that "the net income *from the property*" should "be computed *without regard* to development expenditures * * * regardless" of the manner of exercise by a taxpayer of the option granted under Article 223 of Regs. 62. G.C.M. 2315, VI-2 Cumulative Bulletin 21,

reproduced in full in the Appendix, *infra,* p. 59. This decision was "*uniformly* followed in closing a great number of cases," not only under the 1921 Act but under the 1924 Act as well. G.C.M. 2315, *supra.* It was also reflected in Art. 201 (h) of Regs. 62, promulgated February 15, 1922. That Article defined "net income from the property" as—

> "the gross income from the sale of all mineral products and any other income incidental to the operation of the property for the production of the mineral products, less *operating* expenses, including depreciation on equipment, and taxes, but excluding any allowance for depletion * * *."

The studied and deliberate distinction drawn by the Treasury itself in Regs. 62 between the "*operating* expenses" which are to be deducted in determining "net income from the property" and the treatment of *development* costs, is shown by comparing Art. 201 (h), quoted *supra,* with Art. 223 of the same regulations, which provided that such latter costs may at the option of the taxpayer be deducted (in determining *taxable* net income)—

> "as a *development* expense."[2]

Now let us examine the legislative history. Under the 1921 Act, Section 234 (a) (9), the depletion allowance was limited to 100% of the "net income * * * from the property upon which the discovery was made." When the Revenue Bill of 1924 was

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[2]The explanation and reasons for this sharp distinction are discussed elsewhere herein.

pending, Mr. A. W. Gregg, then Special Assistant to the Secretary of the Treasury and later General Counsel for the Bureau of Internal Revenue, prepared, for the use of the Committee of Finance, a Statement of Changes made in the Revenue Act of 1921 by H. R. 6715.[3] The following pertinent statement appears on page 15:

> "The existing law limits discovery depletion to the *operating profit* from the property upon which the discovery is made. The bill limits discovery depletion to 50 per cent of the *operating profit* upon which the discovery has been made. Experience in administering the law has shown that the limitation imposed by the existing law is not a sufficient limitation, and it has been concluded that 50 per cent of the *operating profit* from the property represents a fair limitation upon discovery depletion."

Obviously, development expenditures—the cost of *getting ready* for production which frequently is never obtained—are not part of the *operating* expense of *producing* oil and are, therefore, not to be reflected in "operating profit."

Again, the report of the Senate Committee on Finance in connection with the Revenue Bill of 1924 contains the following statement:[4]

> "The exception contained in subdivision (c) supersedes the second and third provisos of

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[3]See Gregg Statement of Changes Made in Revenue Act 1921 by Treasury Draft and Reasons Therefor, found in Klein, Federal Income Taxation, Appendix, p. 308.

[4]Senate Report No. 398, 68th Congress, First Session, p. 20.

section 214 (a) (10) and 234 (a) (9) of the existing law. The existing law limits discovery depletion to the *operating profit* from the property upon which the discovery is made. The bill limits discovery depletion to 50 per cent of the *operating profit* from the property upon which the discovery has been made."

The Report of the Committee on Ways and Means on the Revenue Bill of 1924 (H. Rep. No. 179, 68th Congress, First Session, p. 18) is to like effect.

In the 1926 Act Congress abandoned depletion based on discovery value and substituted percentage depletion, so-called. Notwithstanding this radical change, Congress nevertheless retained, as a *limitation* on percentage depletion, the identical language of prior Acts with respect to the limitation on discovery depletion. See Report of Committee on Ways and Means on Revenue Bill of 1926 (H. Rep. No. 1, 69th Congress, First Session, p. 6):

> "The discovery depletion deduction limitation of an amount not in excess of 50 per cent of the net income of the taxpayer from the property upon which the discovery was made, provided in existing law, is *retained* in this provision."

Report of Senate Finance Committee (S. Rep. No. 52, 69th Congress, First Session) contains a similar statement at page 17. The Conference Report (H. Rep. No. 356, 69th Congress, First Session) contains a similar statement at page 32.

Never in any Regulation or Treasury Decision adopted prior to February 15, 1929, did the Treasury

suggest that a meaning be assigned to "net income from the property" different from that which had been consistently applied in the administration of the Revenue Act of 1921 and subsequent Acts. There is, therefore, nothing in this record to suggest that Congress, on May 29, 1928, intended the phrase to have a radically different meaning from the approved meaning of *identical* language as used in three prior Acts. On the contrary, the Committees of Congress had the depletion provisions called particularly to their attention in drafting the 1928 Act. The House Bill made no change in existing law with respect to either depreciation or depletion.[5] But the Senate Bill made changes, in which the House later concurred,[6] to "amend and clarify" the law governing the manner in which the deductions for depreciation and depletion shall be apportioned as between life tenant and remainderman or trustee and beneficiary. If Congress, in 1928, had not been satisfied with the Treasury's long-continued interpretation of "net income from the property", is it not reasonable to assume it would have amended the statute?

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[5]See statement to that effect in Senate Finance Committee Report (S. Rep. No. 960, 70th Congress, First Session, p. 20). Appendix, *infra*, p. 61.

[6]Conference Report on the 1928 Revenue Bill (H. Rep. No. 1882, 70th Congress, First Session, p. 11), Appendix, *infra*, p. 62.

II. The Treasury Construction of the Earlier Revenue Acts Was Correct. For the Same or Greater Reasons Its Regulations Under the 1928 Act Are Wrong.

If the considered construction and administration adopted by the Treasury in 1921, G.C.M. 2315, *supra*, cannot be said to have been clearly right as an original proposition, certainly it cannot be said to have been clearly wrong. The situation here in this respect is like that involved in *Helvering v. Reynolds Tobacco Co.*, 306 U. S. 110. This Court recognized, as did the Court below, that the question in the *Reynolds* case was "at least a debatable" one and that the statute was "so general in its terms as to render an *interpretative* regulation appropriate." Certainly, by comparison, the *original* Treasury interpretation involved in the *Reynolds* case was far more debatable than the Treasury's 1921 interpretation of "net income from the property."

Whether clearly right or merely fairly debatable, Congress, in 1924, knew of the administrative practice and approved of it. In view of the legislative history discussed above, it is clear that at least by May 29, 1928—date of approval of the statute applicable here—the meaning of "net income from the property" had been made "plain" and thus we have a situation which comes squarely within the doctrine of *Biddle v. Commissioner*, 302 U. S. 573, 582, where this Court said:

> "Where the law is plain the subsequent reenactment of a statute does not constitute adoption of its administrative construction. Iselin v. U. S.,

270 U. S. 245 * * *; Louisville & N. R. Co. v. U. S., 282 U. S. 740 * * *; Helvering v. New York Trust Co., 292 U. S. 455 * * *."

As the Commissioner's brief points out (p. 12), this Court has held that the term, "gross income from the property," to which the 27½% factor is applied, means the "gross income from the oil and gas." *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312, 321. Clearly it does not embrace items of income such as interest on bonds owned by an oil company. Hence the term is not synonymous with the shorter, but nevertheless more inclusive, term, "gross income," as used in Section 22. This being so, "net income from the property" necessarily cannot be synonymous with the *taxable* "net income" of Section 21.

The term, "net income from the property" is correlative with the term, "gross income from the property," used in the same sentence. If the latter means "gross income received from the *operation* of the oil and gas wells by one who has a capital investment therein—not income from the *sale* of the oil and gas properties themselves," *Helvering v. Elbe Oil Land Development Co.*, 303 U. S. 372, 376, "net income from the property" must necessarily reflect only such deductions as relate to the *operation* of the wells in the *production* of oil and gas. Development expenditures are made *before* the period of operation and production begins—and unfortunately, in many instances, without ever reaching the stage of production. Therefore, they can have no relation to "net income from the property."

III. The Commissioner's Argument Analyzed and Considered.

1. The percentage depletion provision permits the deduction of "an arbitrary allowance * * * without reference to cost." *U. S. v. Dakota-Montana Oil Co.*, 288 U. S. 459, 461.

The Commissioner argues (p. 8) that Congress, by allowing percentage depletion of oil and gas wells, has singled them out "for *favored* treatment." So also has Congress determined, as a matter of legislative policy, that gains from sale or exchange of capital assets shall be taxed at lower rates than, for example, interest on bonds or dividends on stock. But such *special* treatment does not authorize the taxing authorities to modify the congressional mandate. If the special provisions are applicable, they should and must be applied as Congress intended, whether or not the administrative authorities consider them "artificial."

The Commissioner suggests (p. 9) that the question had arisen years ago as to whether development expenditures "were deductible from gross income as business expenses or whether they were in the nature of capital outlays." Query, whether this was the question really considered—back in 1918[7]—or whether the real question was not whether, regardless of their character, the revenues would not be equally well served, over a period of years, if taxpayers were allowed, at their option, to deduct such expenditures in determining *taxable* net income? Support for this

[7]Cf. footnote 6, Commissioner's brief, p. 10.

view is lent by the requirement of consistency from year to year "for all subsequent years."

The option of deducting currently, when coupled with the condition that the same practice be followed "for all subsequent years", is not an unmixed blessing. As the Court of Claims, in *McDuffie v. United States*, 19 F. Supp. 239, 245, said:

> "True, in some instances the exercise of the option noted may not result advantageously to the taxpayer. That, however, is a matter to be anticipated in the exercise of the right. Plaintiff by capitalizing the expenses here involved could have obtained whatever advantages accrue from the same, but by pursuing the opposite course he obtained and indispensably made the items proper in determining the cost of the product on hand at the close of the taxable year. * * *"

The term "net income from the property" is not to be found in the 1918 Act. Under that Act, therefore, the terminology of the Regulations was unimportant. It mattered not, once the Commissioner and the Secretary had decided to permit optional treatment, how development expenditures were labelled. Hence, in Art. 223 of Regs. 45, under the 1918 Act—the first regulations granting the option—development expenditures were described as an "*operating* expense" if—but only if—a taxpayer chose to deduct them in computing taxable net income. As if the choice of methods in the tax return could determine the essential nature of such expenditures!

"Net income from the property" first appeared in Sec. 234 (a) (9) of the 1921 Act, as a *limitation* on discovery depletion. It thus became necessary to be more precise in the description of development expenditures; if they were "*operating* expenses", then obviously they should be deducted in determining "net income from the property," which was an *operating* concept. The Treasury having decided, G.C.M. 2315, *supra*, that these expenditures had no proper place in the computation of "net income from the property"—because they were incurred *prior* to the time of operation and production—naturally had to correct the inapt label used in the 1918 Regulations. It is significant that in Art. 223 of Regs. 62, under the 1921 Act, the term "*development* expense" was substituted for "*operating* expense." The change was obviously a deliberate one and has been continued to the present time.

The Commissioner's brief (p. 10) is unfair in seeking to convey the impression to this Court that this taxpayer was free to choose, in the taxable years 1929 and 1930, whether it would capitalize or deduct currently its development costs of those years. The fact is that the taxpayer was bound, by contract with the Commissioner, *cf. Ilfeld Co. v. Hernandez, supra*, to deduct these items in its 1929 and 1930 returns. [R. 53; Art. 223, Regs. 69; Art. 243, Regs. 74.] Contrary to the Commissioner's assertion (pp. 10-11), the taxpayer made no claim in its tax returns that they were capital outlays; it did, of course, deduct them in determining its *taxable* net income—exactly as it did in 1925 and, in accordance with its agree-

ment, has done every year since, when such development costs have been incurred. The taxpayer has thus been thoroughly consistent, but as much cannot be said for the conduct of the Commissioner.

2. The mere deduction of development costs in computing taxable net income does not, of course, change their nature. But even if such treatment converts them into "business expenses," they are nevertheless not expenses incurred in the *operation* of the wells in the *production* of oil and gas. *Cf. Helvering v. Elbe Oil Land Co., supra.* Hence they did not affect "net income from the property" any more in the taxable years 1929 and 1930 than in 1921, when the original Treasury construction was adopted after full consideration.

The Commissioner can hardly be serious (p. 11) in treating the taxable net income of Section 21 as the same thing (except for the depletion allowance itself) as the "net income from the property" of Section 114 (b) (3), especially in view of what this Court said in *Helvering v. Twin Bell Oil Syndicate, supra.*[8] If the taxpayer had owned some shares of stock of the Standard Oil Company, purchased with proceeds of oil previously extracted, and had sold them at a gain of $100,000, we may be sure the Commissioner would have imposed a tax on such gain—and rightly so, because it would have augmented the "net income" of Section 21. But would the Commissioner have permitted the taxpayer to include such gain in "gross income from the property" and take an *additional*

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[8]Compare, also, G. C. M. 5104, C. B. VII-2, p. 115.

depletion deduction of $27,500? Clearly not—and rightly so.

The Commissioner (p. 12) invokes the maxim, *expressio unius est exclusio alterius*. This maxim was held inapplicable for reasons adequately stated in Circuit Judge Garrecht's opinion in *Ambassador Petroleum Company v. Commissioner*, 81 F. (2d) 474 at 478-9. Its application was also successfully resisted by the Government in *Phipps v. Commissioner*, 91 F. (2d) 627, 629 (C.C.A.-10, 1937), certiorari denied, 302 U. S. 742, and *Hamersley v. U. S.*, 16 F. Supp. 768, 83 Ct. Cl. 687, certiorari denied, 300 U. S. 659, where a gift tax was sustained when applied to transfers by gift of Liberty Loan bonds which, by statute, were exempt,—

> "* * * from *all* taxation, *except* estate or inheritance taxes * * *."

The Solicitor General has evidently overlooked the successful argument to this Court by his eminent immediate predecessor in opposition to certiorari in *Hamersley v. U. S., supra* (No. 564, October Term, 1936). At page 9 of his brief, Solicitor General Reed said:

> "In the light of the history of the exemption clause, we submit that the insertion of the phrase 'except estate or inheritance taxes' added nothing to the exception granted and was not intended to broaden the scope of the exemption. Accordingly, there is no room for the application of the principle *expressio unius est exclusio alterius*, the purpose of which is primarily to resolve an ambiguity or doubt and not to require a construction of words which is contrary to their historical and

settled legislative meaning or which leads to an anomalous result. Cf. Shurtleff v. United States, 189 U. S. 311; Continental Bank v. Rock Island Ry., 294 U. S. 648, 677-678; Ford v. United States, 273 U. S. 593, 611-612; Holy Trinity Church v. U. S., 143 U. S. 457."

In the case of *Hatfield v. Commissioner*, 38 B. T. A. 245, 247, the Board held that the provisions of Section 22 (a) of the Revenue Act of 1934, providing for the inclusion in gross income of the salaries of "judges of the United States taking office after June 6, 1932," did not exempt, under the rule of *expressio unius*, the 1934 salary of a judge of the United States Court of Customs Appeals who took office in 1923. This opinion contains at page 247 an excellent discussion of the *expressio unius* rule, and clearly shows that it is not applicable here. One obvious reason for the parenthetical expression "(computed with allowance for depletion)" was doubtless the desire of Congress to simplify the *computation* of the *limitation* on the percentage depletion allowance itself.*

We agree with the Commissioner (p. 12) that the term "net income from the property" should be taken in its natural sense, but the conclusion drawn by the Commissioner merely begs the question here at issue.

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*If the Solicitor General disagrees, perhaps he will submit a formula for ascertainment of "net income from the property" computed *with* allowance for percentage depletion. Cf. *Edwards v. Slocum*, 264 U. S. 61, affirming 287 F. 651, where this Court referred with approval to the statement of Circuit Judge Hough: "We * * * hold that the presumption is that Congress intended a simpler method—one that a plain man could understand. Algebraic formulae are not lightly to be imputed to legislators."

For one thing, this Court may wish to inquire of the Commissioner how, if the construction now contended for by him is such a "natural" one, it completely escaped the Commissioner and the Secretary from 1921 to 1929. We say that development expenditures, which are incurred *prior* to operation of the well and production of oil and gas, have no more natural connection with "net income from the property" than the proceeds of sale of an oil well have a bearing upon or are includible in "gross income from the property". *Cf. Helvering v. Elbe Oil Land Development Co., supra.*

3. The Commissioner's argument (p. 12) suggests that his position is supported by "administrative practice of some *twelve* years' standing." The regulation in question was first adopted in 1929. That is the first of the two taxable years here involved. Theoretically at least, the true tax liability for 1929 should be ascertainable on December 31, 1929. Neither the Government's rights nor a taxpayer's obligations should be increased or lessened by reason of a ten-year delay in their *adjudication;* the appeal to the Board herein was filed July 28, 1932, more than seven years ago [R. 1].

The Commissioner fails to state that his present attempted practice represents an "about-face"[10] from

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[10]To borrow from Circuit Judge Swan in *Bliss v. Commissioner*, 68 Fed. (2d) 890, 893, affirmed *Helvering v. Bliss*, 293 U. S. 144.

the *original* considered Treasury practice adopted in 1921, which was thrice approved by Congress. In *Koshland v. Helvering*, 298 U. S. 441, the Commissioner relied upon "Treasury Regulations long in force." But although successive statutes had been enacted, without change in their language, this Court held that the regulations could not be given effect because the pertinent provisions of the statute were unambiguous and specific and the Secretary of the Treasury had no power to amend them. Compare, also, *Boca Ratone Co. v. Commissioner* (C.C.A.-3), 86 Fed. (2d) 9.

If "Treasury Regulations long in force" would not sustain the Commissioner in the *Koshland* case, it is obvious that he can expect no assistance from a regulation which was not promulgated for the first time until after the passage of the statute here involved. And especially is this so when that regulation is contrary to the *only* judicial interpretation of *identical* language in the 1926 Act.

Ambassador Petroleum Co. v. Commissioner, 81 F. (2d) 474, was decided February 5, 1936. The Commissioner allowed May 5, 1936 to pass without applying for certiorari. Nor did he ever litigate to the point of decision any other case under the 1926 Act. The Revenue Act of 1936 was not approved until June 22, 1936. If the Commissioner was dissatisfied with the decision in the *Ambassador* case, why did he

not attempt to convince Congress that it was wrong and have the rule changed in the 1936 Act?[11] The case at bar was decided by the Board on April 30, 1937 [R. 57] and by the Court below on April 1, 1938 [R. 79]. The Revenue Act of 1938 became effective May 28, 1938. Why did not the Commissioner attempt to get Congress to change the statute in 1938? If the Commissioner's construction of "gross income from the property", *approved* by this Court in *Helvering v. Twin Bell Oil Syndicate, supra,* justified the making of a "clarifying amendment" in the Revenue Act of 1932, where the administrative construction had been uniform and consistent, it would seem that the Commissioner, at the same time, should have asked Congress for an amendment, approving for the future, the construction he now seeks to impose on this taxpayer.

The Commissioner next contends (pp. 13-14) that if the change first made in 1929 may not be justified under the general power "to prescribe all needful rules

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[11]The Commissioner was dissatisfied with the decision in *Cole v. Commissioner,* 81 F. (2d) 485, decided December 20, 1935, by the same three judges who decided the *Ambassador* case. Yet he did the proper thing with respect to the rule of the *Cole* case; he went to Congress and got the statute changed, *but only for the future.* See the entirely new provision which appeared as Section 53(b) of the Revenue Act of 1938 and its legislative history as contained in Report on the Revenue Bill of 1938 by House Subcommittee on Internal Revenue Taxation, January 14, 1938. *Hassett v. Welch,* 303 U. S. 303, shows that he went to Congress because of dissatisfaction with the decisions of this Court in *May v. Heiner,* 281 U. S. 238, and *Burnet v. Northern Trust Co.,* 283 U. S. 782.

and regulations" (Section 62 of the Act of 1928), it may be sustained under the special power conferred by Section 23 (1), as shown in italics below:

> "*Sec. 23. (1) Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; *such reasonible allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary.* In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For percentage depletion in case of oil and gas wells, see section 114 (b) (3).)"

While respondent must concede that Section 114 (b) (3)—the arbitrary percentage depletion provision—is not to be read independently of Section 23(1)—the "reasonable allowance for depletion" provision—*Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312,[12] nevertheless it may be doubted, in view of the context

[12] A case not cited in the Commissioner's brief.

and statutory history of Section 23 (l), whether the regulatory power specially conferred therein extends to the percentage depletion allowance. However this may be, this special power certainly would not authorize the Commissioner to change, by regulation, the plain meaning of Section 114 (b) (3). It would not authorize him to rule, for example, that in the case of oil property held by one person for life with remainder to another person, the depletion deduction shall be apportioned (as in the case of a trust) when Section 23 (l) expressly requires that the entire deduction shall be allowed to the life tenant. Certainly, also, this special power, if applicable to Section 114 (b) (3), would not justify a regulation providing, for example, that the percentage depletion allowance shall be 15% of the "gross income from the property" but shall not exceed 25% of the "net income from the property." For this Court to permit the Commissioner, by regulation, to change the measure of "net income from the property" from time to time, especially in the radical manner which he is attempting here, would be to approve a result equally as contrary to the intention of Congress on May 29, 1928, as though the Commissioner had, by regulation, attempted to change the percentage factors themselves.

The Commissioner argues (p. 14) that regulations made pursuant to Section 23 (l) are "*legislative* in character rather than purely interpretative." He cites no authority for that position. For its refuta-

tion, we need look no further than *Manhattan General Equipment Company v. Commissioner*, 297 U. S. 129, 134, where this Court said:

> "The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law, *for no such power can be delegated by Congress*, but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity. Lynch v. Tilden Produce Co., 265 U. S. 315, 320, 322, 44 S. Ct. 488, 68 L. Ed. 1034; Miller v. United States, 294 U. S. 435, 439, 440, 55 S. Ct. 440, 79 L. Ed. 977, and cases cited. And not only must a regulation, in order to be valid, be consistent with the statute, *but it must be reasonable*. International R. Co. v. Davidson, 257 U. S. 506, 514, 42 S. Ct. 179, 66 L. Ed. 341. * * *."

But even if it be conceded that the special power of Section 23(l) be legislative in character, the Commissioner had the same statutory authority under the earlier revenue acts and his power to legislate in a way diametrically opposed to his original construction was cut off by Congressional approval, in 1924, 1926 and 1928, of the original regulations and practice. Any other holding by this Court would authorize the Commissioner to adopt legislative regulations directly in conflict with a statutory provision, rather than carrying out the intendment of the statute.

The Board and the Court below held the regulation invalid not because they differed with the Commis-

sioner's "exercise of discretion," as he asserts (p. 15), but because the regulation, first promulgated after the enactment of the statute applicable here, conflicted with the intention of Congress as clearly disclosed by the legislative history of the statute and two prior statutes.

Biddle v. Commissioner, supra, is a complete answer to the Commissioner's argument (p. 15) as to the effect of the enactment of the Revenue Act of 1932 and subsequent Acts. None of the cases cited by the Commissioner (p. 15) supports his position here. The Government prevailed in all but one of the cases cited, but in all of these the administrative construction was not only long-continued, but was uniform. *Hassett v. Welch,* 303 U. S. 303, which the Government lost, involved, as here, an attempted "about-face" from an earlier Treasury construction of an earlier but similar statute. This decision, therefore, supports the position of the respondent here, as does *Brewster v. Gage,* 280 U. S. 327, 337, where this Court indicated that it did not approve of a reversal of administrative construction, particularly where, as here, it "would be likely to produce inconvenience and result in inequality."

We have no quarrel in principle with the Commissioner's assertion (p. 15) that the rule as to the effect of reenactment of statutes without change applies with equal force where the taxable year precedes the reenactments and is governed by the *original* statute rather than where it is governed by one of the reenacting statutes. But the "original statute" with which we are concerned is the Revenue Act of 1921, where the term "net income from the prop-

erty" originated. For example, the enactment of the Revenue Act of 1924 had a dual effect; (1) it *approved* the Treasury construction of the Act of 1921; (2) it *adopted* that construction as the meaning to be given to identical language in the Revenue Act of 1924. When Congress, in 1926, made the radical change from discovery to percentage depletion and expressly said[13] that—

> "* * * The provision of *existing* law *limiting* this amount to an amount not in excess of 50 per cent of the net income of the taxpayer from the property is *retained*."—

it adopted, for the second time, the original, uniform and consistent Treasury construction of the Acts of 1921 and 1924. That the Commissioner must have believed this was so is shown by the fact that Reg. 69, under the 1926 Act, made no attempt to change the construction which had been in effect since 1921. Not until 1929 did he, most belatedly, get the idea that the change from discovery to percentage depletion required him to change the meaning of the *limiting* formula. And even then it was not consistent, for he made no attempt to change the regulations covering the years 1925, 1926 and 1927, governed by the 1926 Act.

4. The Commissioner erroneously urges (p. 16) that the practical effect of the decision below is to permit a double deduction for the same expenditure, since the taxpayer immediately secures a deduction

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[13]House Report No. 356—Conference Report, 69th Congress, 1st Session, p. 32.

of 100 per cent of the development costs (which is true, provided the taxpayer has any income from other sources in the particular year), *plus,* says the Commissioner—

> "a further deduction when the sum is excluded from depletion computation."

There are several answers to this contention.

(a) The alleged "further" deduction arises, not because development costs are excluded from the computation, but because the clear command of the statute is that the taxpayer shall have an alternative deduction equivalent to 27½% of the "*gross* income from the property", subject only to the privoso that it shall not exceed 50% of the "net income from the property." Thus the only question is whether the deduction, based primarily on *gross,* shall be *cut down* by including the development costs in the computation of the *net.* The deduction may never, in any case, exceed 27½% of the gross.

It may be stated as a rule of *universal* application that the exclusion of development costs, pursuant to the decision of the Court below, will not serve to enlarge the percentage depletion *unless* the taxpayer's expenditures on "the property," *including* development costs, exceed 45% of the "gross income from the property." And in those cases where development costs serve to bring the expenditures on "the property" to more than 45% of gross income, the depletion allowance is cut down by *only one-half* of the *excess* over 45% of gross. In other words, if the development expenditures were, say, $10,000, their exclusion from the computation might, in a

given case, increase the depletion allowance by any figure between *one-half cent* and $5,000, but such exclusion could in no case serve to increase the amount deductible to more than 27½% of the "gross income from the property."

Applied to the case at bar, let us examine the figures at page 26 of the Commissioner's brief. Under his theory, the taxpayer gets no percentage depletion allowance whatever, although oil worth $370,448.72 was extracted from the properties. Under the rule of the Court below, the taxpayer gets a deduction of $42,528.91, which is 11.4% of the gross income from the property, as compared with the upper limit of 27½%, which would be $101,873.40.

The taxpayer did, of course, get a deduction, in determining *taxable* net income, of the amount of its *development* costs, namely, $279,927.04, because it complied with its 1925 promise.[14] The Commissioner complains that the taxpayer should not get a "double deduction," yet we find that $42,528.91 is approximately 15% of $279,927.04—far, we submit, from a double deduction.

(b) The result which the Commissioner chooses to label a "double deduction" arises directly from the option, granted since 1918, to deduct development costs in computing *taxable* net income and the propriety of which is not in issue here. To illustrate:

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[14]If taxpayer had sold these properties subsequent to development, say in 1931, the Treasury would have benefited from the deduction taken in 1930 because the $279,927.04 would have been wholly excluded from the cost basis in computing gain. *Ramsey v. Commissioner*, 66 F. (2d) 316.

Frequently development costs, or the major portion of them, are incurred prior to the taxable year in which production begins. If an operator in such circumstances has income from other sources, these development costs will be deducted in full from this income. Then, in the next year and the succeeding years in which production is secured, the Commissioner must admit that these prior-year development costs will not be taken into consideration in computing the depletion limitation.

To illustrate further: Suppose an oil operator, in the early part of his taxable year, spends $25,000 in development costs. Then, in the later portion of the same year—after the well has been brought in—he incurs *production* expense of $20,000 in producing a gross income from the property of $100,000. Even if the Commissioner's views were applied, the "net income from the property" would be $55,000 and 50% thereof, or $27,500, would exactly equal 27½% of the $100,000 gross. It is obvious, therefore, that the rule for which the Commissioner contends will not obviate the result of which he complains except in those cases where the cost of development, added to the cost of production, bears a high ratio to the oil recovered. Thus the Commissioner's rule hits only those operators least able to bear its burden.

(c) Assuming the Commissioner's characterization of "double deduction" were apt, which we deny, the question immediately arises whether it was not equally true under the prior acts, beginning with the Act of 1921. If so, why did it take the Commissioner eight years to discover it? Indeed, it was even more true under the 1921 Act, which contained a limitation of

100% of the "net income from the property," than under the 1924 Act and all subsequent statutes, where the limitation is 50%. This is obvious from the figures at page 26 of the Commissioner's brief—if the limitation were 100%, the Court below would have allowed a depletion deduction of $85,057.82 instead of $42,528.91.

5. As we read the Commissioner's argument (p. 17), he clearly asserts that *both* the earlier statutes *and* the regulations thereunder are "quite different" from the Revenue Act of 1928 and the regulations thereunder. This assertion is true only in minor part. The regulations, we admit, are "quite different," but the *pertinent* portion of the Act of 1928—the *limiting* formula of "net income from the property"—is *identical* with similar language in the Acts of 1921, 1924 and 1926.

Even if the Commissioner adheres, at the oral argument, to the erroneous assertion just mentioned, he must concede that there was no difference whatever between the pertinent provisions of the Acts of 1926 and 1928. Will he cite to this Court any article of Regs. 69, under the 1926 Act, which in any way resembles Art. 221(i) of Regs. 74, the validity of which is at issue here? Taxpayer knows of no such Regulation and the Commissioner's failure to issue proper Regulations under the 1926 Act can hardly strengthen his position here. Quite the contrary, in view of the Regulations under the Acts of 1921 and 1924.

The Commissioner's description (p. 19) of the decision of the Court below is not correct. The lower Court did not concede that the provisions of the

1928 Act were different from those of earlier statutes. Neither did the Court concede, any more than we do, that the Regulations issued in 1929 were "prospective only." Does the Commissioner assert that these Regulations, promulgated for the first time February 15, 1929, were not attempted to be applied to the year 1928? If so applied, would they still be "prospective only"? Will the Commissioner deny that many oil operators incurred development costs during 1928 and deducted them in determining taxable net income for that year only because they were bound to do so by reason of an election made under Art. 223 of Regs. 69? Will the Commissioner deny that he is holding taxpayers to an election made long before his new Regulation was promulgated on the faith of a diametrically opposite administrative construction? How, then, may it *fairly* be said that the 1929 Regulations are prospective only?

The real issue in this case appears from an examination of paragraph (a) on page 19. If this Court agrees with the Commissioner's sweeping contentions there stated, and further agrees that the 1929 Regulations were prospective only, as applied to this taxpayer, then it will presumably reverse the Court below.

The Commissioner asserts (p. 19) that the statute itself, Sec. 605 of the Revenue Act of 1928, gives the Commissioner the power to issue new regulations which may change the law. Such a contention was rejected in *Helvering v. Reynolds Tobacco Co.*, 306 U. S. 110, where this Court said:

> "* * * It is clear from this provision that Congress intended to give to the Treasury

power to correct misinterpretations, inaccuracies, or omissions in the regulations and thereby to affect cases in which the taxpayer's liability had not been finally determined, unless, in the judgment of the Treasury, some good reason required that such alterations operate only prospectively. The question is whether the granted power may be exercised in an instance where, by repeated reenactment of the statute, Congress has given its sanction to the existing regulation.

"Since the legislative approval of existing regulations by reenactment of the statutory provision to which they appertain gives such regulations the force of law, we think that Congress did not intend to authorize the Treasury to repeal the rule of law that existed during the period for which the tax is imposed. * * *."

Furthermore, the attempted change in the regulations here involved actually has a clear retroactive effect, as applied to this taxpayer, and withdraws one of the important inducements offered by the Treasury in connection with the contract made in taxpayer's return for the year 1925. Nothing like this situation was present in either *Morrissey v. Commissioner*, 296 U. S. 344, or *Murphy Oil Co. v. Burnet*, 287 U. S. 299, cited by the Commissioner at page 20.

Morrissey v. Commissioner is readily distinguishable. The decision in *Crocker v. Malley*, 249 U. S. 223, involving the application of the 1913 Act to "associations," was rendered in March, 1919. The Treasury thereafter issued its Regulations under the 1918 and 1921 Acts consistently with the decision in *Crocker v. Malley*, but, apparently, without noting or observing that the pertinent language of the 1913

Act was narrower in its scope than the somewhat comparable language of the 1918 and 1921 Acts. Not until the case of *Hecht v. Malley*, 265 U. S. 144, was decided in May, 1924, did the Treasury realize the distinction between the scope of the 1913 and 1916 Acts, on the one hand, and the 1918 and 1921 Acts, on the other.

In drafting its Regulations under the 1924 and 1926 Acts, applicable in *Morrissey v. Commissioner*, the Treasury made them conform to *Hecht v. Malley*. In deciding the *Morrissey* case this Court said that Regulations may be "*clarified* or *enlarged* so as to meet administrative exigencies or *conform* to judicial decision." Most assuredly, Regulations may be revised, but the Commissioner has failed to cite any authority to the effect that Regulations may be changed in a manner that makes them *inconsistent* with the statute. Regulations 74 are concededly inconsistent with the prior administrative interpretation of the earlier Acts and with the meaning of the 1926 Act as expounded in the *Ambassador Petroleum Co.* case. How, then, can they be otherwise than inconsistent with identical language of the 1928 Act unless it be shown that the Congress which enacted the 1928 Act intended the phrase to be given a meaning diametrically opposed to that which was adopted by the Congress which passed the 1926 Act? The Commissioner's brief fails to furnish a satisfactory answer to this question—and it is clear that there can be no such answer.

Murphy Oil Co. v. Burnet, supra, likewise does not support the Commissioner. It involved the taxable years 1919 and 1920. The *original* regulation,

construing the applicable Revenue Act of 1918, was Art. 215 of Treasury Regs. 45 (1920 Ed.). It is well known that tax cases for the years 1919 and 1920 were not settled for many years, being kept open by waivers of the statute of limitations and claims for refund. While these years were still open, the Treasury, in 1926, amended Art. 215 of Regs. 45. True, in the meantime, the Revenue Acts of 1921, 1924 and 1926 had been enacted. The original regulation, as issued in 1920, was not only clearly wrong (as applied to situations where the sum of a bonus and expected royalties exceeded the lessor's capital investment in the oil in ground) but the retroactive amendment thereof, issued in 1926, prevented the harsh results which the original regulation—if valid—would have imposed on certain lessors. It was thus not only corrective but ameliorative also. To illustrate: If, for example, the lessor's capital investment were $500,000, the bonus were $1,000,000, and the estimated royalties were $2,000,000, the lessor would have had to report, under the 1920 Regulation, $500,000 of the bonus as return of capital, the *entire* balance as income in the year of receipt, and would have had no depletion allowance against the royalties when received in subsequent years. The 1926 amendment was far more reasonable because it provided for an allowance for depletion in every year during which the oil was extracted.

On the facts shown of record in the *Murphy Oil* case the result was the same under either the original Regulation or the 1926 amendment thereof. Certainly the decision is not authority for allowing the Commissioner to issue a regulation in defiance of

the plain meaning of a statutory provision of eight years' standing. After all, "not only must a regulation, in order to be valid, be consistent with the statute, *but it must be reasonable.*" *Manhattan General Equipment Co. v Commissioner, supra.* Certainly, Art. 221(i) is not reasonable as applied to this taxpayer or any other who made an election prior to the change.

The Commissioner's argument (p. 21), in referring to the Revenue Act of 1928, utterly and incorrectly disregards the fact that, so far as material here, it was merely the reenactment of a statute originally enacted in 1921. The Commissioner's argument, not the holding of the Court below, is the one which leads to an "extraordinary conclusion," namely, that the mere reenactment of a tax statute, using the identical language of three prior Acts, empowers the Commissioner to disregard the plain meaning of the statutory language. House Report No. 356, 69th Congress, 1st Session, pp. 31-32, asserts that percentage depletion was being substituted for discovery depletion "in the interest of simplicity and certainty of administration * * *." How could there ever be any certainty as to the meaning of taxing statutes if this Court were to approve the proposition advanced by the Commissioner?

The Commissioner suggests (p. 22) that the instant case is sharply to be distinguished from *Helvering v. Reynolds Co., supra.* On the contrary, we submit that it is not fairly distinguishable and that the reasoning of the *Reynolds* case requires the affirmance of the decision of the Court below.

In the *Reynolds* case, as in the instant case, the question involved related to the construction of the Revenue Act of 1928—in short, what was meant by the statutory language on May 29, 1928, the date on which the Act of 1928 was approved?

Each case involved an *attempt* by the Commissioner, by regulation, to *change* the meaning which had been consistently given to identical language in revenue acts prior to the Act of 1928. In the present case, this attempt occurred nine months after the approval of the Act of 1928, while in the *Reynolds* case the attempt did not occur for nearly six years, viz., May 2, 1934.

In the *Reynolds* case the Commissioner argued that because Congress reenacted Section 22 (a) in the Revenue Acts of 1936 and 1938, it approved the *amendment* of May 2, 1934 to Art. 66 of Regs. 74 (promulgated under the 1928 Act). This Court held that the passage of the 1936 and 1938 Acts did not have such an effect; that the taxpayer's liability for 1929 "is to be determined in conformity to the regulations then in force." This Court's reason for this holding is stated in the first sentence of the concluding paragraph of its opinion: the reenactment of Section 22 (a) in the Act of 1928 amounted to legislative approval of the *predecessors* of Art. 66 of Regs. 74, construing the *predecessors*, in the 1926 and earlier Acts, of Section 22 (a) of the 1928 Act.

By similar reasoning it must, we submit, be held in the present case that when Congress employed the term, "net income from the property," in Section 114 (b)(3) of the 1928 Act, it intended that it should

be given the same meaning as identical language in the Acts of 1921, 1924 and 1926, *especially* when the reports of the Committee on Ways and Means and the Senate Finance Committee show that Congress specifically approved the *original* administrative construction.

This Court, in the *Reynolds* case, referred to the suggestion of the Second Circuit in a similar case, *Squibb & Sons v. Helvering*, 98 F. (2d) 69, 70, that the alteration of the "existing" rule—that is, the rule prior to the attempted amendment—"requires a legislative declaration." It then stated that this was a question which it "need not now determine." It then added—

> "It may be that by the passage of the Revenue Act of 1936 the Treasury was authorized thereafter to apply the regulation in its amended form. But we have no occasion to decide this question since we are of opinion that the reenactment of the section, without more, does not amount to sanction of retroactive enforcement of the amendment, in the teeth of the former regulation which received Congressional approval, by the passage of successive Revenue Acts including that of 1928."

The language just quoted might well, it would seem, be adapted to the instant case merely by substituting the words, "Revenue Act of 1932" for the words, "Revenue Act of 1936." This, in effect, is what Judge Denman said in his opinion in the instant case. [R. 75].

In *National Home Owners Service Corp. v. Commissioner*, 39 B. T. A. 753 (No. 101), the Board of Tax Appeals had to consider whether Treasury Decision 4430, promulgated May 2, 1934, could be applied in determining tax liability for the years 1934 and 1935. The Board observed that the final changes in the Revenue Bill of 1934 were agreed to by both Houses on May 3, 1934, one day after issuance of T. D. 4430, but that the legislative history did not indicate that T. D. 4430 was brought to the attention of Congress. The Board then stated that the question was whether, since Congress had given the old administrative construction the force of law, "the Commissioner could *change* the law by amending his regulation or whether a change in the law would have to come from the legislature. *Cf. Squibb & Sons v. Helvering*, 98 Fed. (2d) 69." After thus stating the question—which is precisely the same as in the case at bar—and after quoting in full the last two paragraphs of the opinion in the *Reynolds Tobacco* case, the Board said:

> "The above quotation rather indicates that the Supreme Court agreed with Judge Learned Hand who said in the *Squibb* case that only legislative enactment could change the well established rule of law, and that there was no change, at least until 1936. Even then the Commissioner could not point back to consistent regulations on the subject. We hold that the Treasury Decision of May 2, 1934, is not applicable in the present case and the petitioner realized no gain from the transactions of 1934 and 1935. * * *"

If the amended regulation in the *Reynolds* case, issued in 1934, could not change the law except possibly beginning in 1936, it is submitted that Art. 221 (i) of Regs. 74 cannot change the law for any year prior to 1932, which was the first revenue statute enacted subsequent to the issuance of the new regulation. Although the construction of the Revenue Act of 1932 is not involved in the case at bar, it may well be that this Court, in No. 26, *F. H. E. Oil Company v. Commissioner*, set for argument immediately following the instant case, may have occasion to decide what, if any, bearing the issuance of the new regulation in 1929 had on the construction to be given to the Act of 1932.

The Commissioner suggests (p. 22) that the new regulations were "foreshadowed" by G. C. M. 2315. This ruling appears in Cumulative Bulletin VI-2, which shows on its front cover that it contains rulings of the Bureau of Internal Revenue made during the months of July to December, 1927. Obviously it could not have been printed by the Government Printing Office until sometime in 1928. Also on the front cover of that Cumulative Bulletin are the following statements:

> "SPECIAL ATTENTION is directed to the cautionary notice on this page that published rulings of the bureau do not have the force and effect of Treasury Decisions and that they are applicable only to facts presented in the published case
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> * * * * * * * *
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> "The rulings reported in the Internal Revenue Bulletin are for the information of taxpayers and their counsel as showing the trend of official opin-

ion in the administration of the Bureau of Internal Revenue; the rulings other than Treasury Decisions have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law which has not been formally approved and promulgated by the Secretary of the Treasury. Each ruling embodies the administrative application of the law and Treasury Decisions to the entire state of facts upon which a particular case rests. It is especially to be noted that the same result will not necessarily be reached in another case unless all the material facts are identical with those of the reported case. As it is not always feasible to publish a complete statement of the facts underlying each ruling, there can be no assurance that any new case is identical with the reported case. As bearing out this distinction, it may be observed that the rulings published from time to time may appear to reverse rulings previously published."

G. C. M. 2315 shows on its face that the only opinion *requested* of the General Counsel related to the Act of 1921. After reciting that the consistent Bureau practice under the 1921 and 1924 Acts had been not to require development costs to be reflected in the computation of "net income from the property," the author proceeded gratuitously to suggest that a like interpretation should not be given to the Act of 1926, even though the pertinent language was identical with that of the Acts of 1921 and 1924. As in so many instances where advice is volunteered, the author's conclusion as to the 1926 Act was based upon a premise so obviously unsound that, before many months had elapsed, the General Counsel had to con-

cede error—cf. G. C. M. 5104, C. B. VII-2, p. 115. That unsound premise was that "net income *from the property*," as used in Section 204 (c)(2) of the Act of 1926—the percentage depletion provision—"should be taken to mean the net income defined in sections 212 and 232 of the Act"—the *taxable* net income provisions.

By express notice and reservation, G. C. M. 2315 "did not commit the Department."[14a] Obviously, therefore, it was a ruling which was neither binding on the respondent nor one with notice of which it was chargeable. Cf. *Helvering v. New York Trust Co.*, 292 U. S. 455, 468.

The proper place for the Commissioner to have "foreshadowed" the change made in 1929 was in Regs. 69, promulgated in August, 1926, under the Revenue Act of 1926. Had he done so, a contention that the change was required by the substitution of percentage for discovery depletion, might have possessed more force.[15] Failing that, the Commissioner should have amended Regs. 69 as originally issued—something he has never done down to the present date. Certainly T. D. 4025, C. B. VI-1, p. 75, approved by the Secretary on June 18, 1927, should have contained

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[14a] A survey of Prentice-Hall Federal Tax Citator Service, pages 2511-2624, 3559-3591, and 4190-4196, discloses that 103 G. C. M.s have been revoked and 137 modified by subsequent Treasury rulings. See, also, C. C. H. 1939 Standard Federal Tax Service, Index Volume, pages 18,031-18,047.

[15] We have, however, shown elsewhere that in changing to percentage depletion the *limitation* formula was expressly "retained."

notice to taxpayers if the Commissioner and the Secretary believed that the shift to percentage depletion required a change in the settled meaning of "net income from the property.". That Treasury Decision reads as follows:

"To Collectors of Internal Revenue and Others Concerned:

"Under the provisions of article 223, Regulations 69, such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of oil and gas property, drilling of wells, building of pipe lines, and development of such property, may at the option of the taxpayer be deducted as a development expense or charged to capital account. The regulations promulgated under the Revenue Acts of 1918, 1921, and 1924 provide for the same option.

"In view of the change in the basis for depletion provided by the Revenue Act of 1926, in the case of oil and gas wells, taxpayers may make a new election as to the treatment of the expenditures above mentioned for taxable periods ending on or after January 1, 1925, but not later than six months after the date of this decision. Taxpayers desiring to make a new election are required to file amended returns for the taxable periods involved within six months from the date of this decision.

C. R. NASH
Acting Commissioner of Internal Revenue.

Approved June 18, 1927.

A. W. MELLON
Secretary of the Treasury."

The only fair conclusion to be drawn from the fact that T. D. 4025 contained no notice whatever of any projected attempt to change the meaning of "net income from the property" is that by June 18, 1927—sixteen months after the passage of the Act of 1926—the alleged necessity for change had not then occurred to the responsible officials of the Treasury.

The undue length of time that it took for the Treasury officials to "discover" the new meaning is itself a factor to be weighed in determining its correctness, for as this Court, in *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 370, said:

> "the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and study of an acute and powerful intellect would discover."—

a statement that is particularly applicable to the percentage depletion provision, which this Court has said is a "rule of thumb" and must be "applied without a detailed examination of the facts affecting each taxpayer" in "the simple manner it contemplates." *Helvering v. Mountain Producers Corp.*, 302 U. S. 681.

It is difficult to perceive how the petitioner's position here is aided by his admission (p. 23) that under the Act of 1926 "the Commissioner made no ruling as to the meaning of the term 'net income'[16] as applied to

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[16]Here, as elsewhere, the Commissioner fails to use the correct statutory language: "net income *from the property*."

percentage depletion of oil and gas properties." The important fact is, as he admits (p. 23), that his "first official ruling" was made under the Revenue Act of 1928 "and is the very one under attack in the instant case."

On page 24 the Commissioner makes a half-hearted concession which disregards the consistent construction which G. C. M. 2315 concedes was given by the Treasury to its own Regulations under the Acts of 1921 and 1924. He refers to the "legislative history" of the 1921 Act and contends that this shows that the original meaning assigned by the Treasury to "net income from the property" was wrong. Respondent concedes that the purpose which Congress had in mind in 1921 in placing a limitation on discovery depletion of 100% of the "net income from the property" was to avoid for the future the result which occurred under the Act of 1918, whereby the unlimited deduction for discovery depletion might absorb not only income from oil and gas but other income of a taxpayer as well. The Commissioner's conclusion drawn therefrom is, however, erroneous. He contends (pp. 25-26) that by deducting development costs in the computation of *taxable* net income the respondent, in 1930, not only eliminated all taxable income *from the four properties involved*, but also obtained the benefit of a $194,869.62 loss. But the Commissioner overlooks the true situation. The development costs of $279,927.04 are not deducted from the gross income from

the properties, but from all the taxpayer's income from all sources. And this was done because of the taxpayer's contract with the Commissioner, made when the taxpayer filed its 1925 return, that it would deduct such costs "for all subsequent years." Furthermore, the *result* of which the Commissioner complains flows from the option, not from the construction of "net income from the property."

The colloquy referred to by the Commissioner (p. 27) indicates nothing more than in the opinion of Senator Jones, of New Mexico, the option, which had been in effect since 1918, should be abolished and taxpayers in the oil business should all be required to charge development costs to capital account. Apparently the Treasury did not share the views expressed by Senator Jones, for the option has been continued in effect down to the present time without disapproval by Congress. The question was not whether development costs were an *operating* expense or a *development* expense, and it is not clear that Mr. Manson was attempting to draw any distinction on this basis. Cf. Art. 243 of Regs. 74, Commissioner's brief, p. 31, where they are described as "development" expense.

6. There is nothing in the taxpayer's position conflicting with *Ramsey v. Commissioner*, 66 F. (2d) 316, and other cases cited on pages 27 and 28 of the Commissioner's brief. Those cases merely hold that intangible drilling and development costs charged off cannot later be treated as a part of the cost of the

property upon a sale. That is the very reason why, after one has elected to charge them off upon the faith of a promise that they will not be used in computing the depletion allowance, and is thereby prevented from capitalizing these costs and getting the benefit of them otherwise, the taxing authorities should not be permitted to change their position. This Court has said, *Helvering v. Mountain Producers Corp., supra,* that asserted equities should not control the construction of the depletion limitation provision, but here the Commissioner asserts equities in his favor which, when they are examined, are found to work the other way.

The statement of the Commissioner (p. 29) that the taxpayer has enjoyed the "advantage" of deducting development expenditures from taxable gross income is only partially true. It falls far short of describing the price paid by the taxpayer for this "advantage," if indeed it may ever be determined that such it is. In the first place, as noted, the taxpayer is deprived of the advantage of counting such expenditures as cost in the event of sale, and is also prevented from including them in the basis for computation of cost depletion. Furthermore, if the Commissioner's contentions are sustained in this case, it will mean that for the year 1930, the taxpayer will get no depletion deduction whatever—cost or percentage—on any of the four properties in question [R. 52, last line], even though it is admitted that its

oil reserve—its capital in the ground—was depleted during 1930 by the extraction of oil worth $370,448.72 (Commissioner's Brief, p. 26).

In the Circuit Court of Appeals both parties relied on *U. S. v. Dakota-Montana Oil Co.*, 288 U. S. 459. Though not mentioned in its opinion in the instant case, it is clear, from the decision in the *Ambassador Petroleum* case, that the Ninth Circuit agreed that it favored the position of the taxpayer. In the *Dakota-Montana* case, this Court said (p. 466):

> "Thus the acts of 1918, 1921, and 1924 were *consistently* construed by the regulations to permit a depletion, but not a depreciation allowance for the costs of development work and drilling, which were treated for this purpose either as a part of the cost or an addition to the discovery value of the oil in the ground. The administrative construction must be deemed to have received legislative approval by the re-enactment of the statutory provision, without material change. (Cases cited.)"

By way of paraphrase, the respondent submits that the acts of 1921, 1924 and 1926 were *consistently* construed by the regulations as not requiring the deduction of development costs in determining "net income from the property"; and that *this* administrative construction must be deemed to have received legislative approval by the reenactment, in 1928, of the statutory provision, without material change.

IV. Helvering v. F. H. E. Oil Company, 102 F. (2d) 596, Is Unsound or at Least Is Distinguishable Since It Involves a Statute Enacted After the Challenged Regulation Was First Adopted.

The Commissioner's brief herein does not even cite the decision of the Circuit Court of Appeals for the Fifth Circuit in *Helvering v. F. H. E. Oil Co.*, 102 F. (2d) 596. The reason for this omission may be that the Commissioner believes that case is distinguishable from the case at bar for reasons suggested in the decision in *Helvering v. Reynolds Tobacco Co., supra*, since it involves a statute enacted subsequent to the first promulgation of the regulation here involved.

However that may be, Circuit Judge Foster, speaking for the Fifth Circuit, did refer to the decision of the lower Court in the case at bar, and said that his Court did not find it persuasive. The opinion in the *F. H. E.* case will, of course, be examined closely in the briefs of the parties in No. 26. In view of that fact, respondent here will make only the following brief observations:

(a) Whatever may be thought of the result, no one can dispute that the opinion is predicated on an erroneous understanding of the earlier statutes. For example, the statement is made that under the Revenue Act of 1924, 50% of the "net income from the property" was a limitation on *cost* depletion. This has never been the case under any of the revenue acts.

(b) The opinion assumes that the limitation provision originated in the 1924 Act; the fact is that it

first appeared in the Act of 1921. This oversight would seem to be important, especially in view of the fact that, contrary to the views expressed by this Court in the concluding sentence of *U. S. v. Dakota-Montana Oil Co.*, 288 U. S 459, the Fifth Circuit seemed to believe that the administrative and legislative history of "net income from the property" was of little, if any, consequence. As this Court said in the case just cited:

> "* * * these cases * * * did not consider the administrative and legislative history, which we think decisive."

V. Summary.

It is believed that this case may well be summarized by a series of questions directed to the Solicitor General, as follows:

1. It is true, is it not, that the Revenue Act of 1918 contained no limitation on depletion based upon "net income from the property"?

2. It is true, is it not, that the Treasury Regulations under the Revenue Act of 1918 (Art. 223, Regs. 45) gave taxpayers an option to deduct intangible drilling and development costs as an *operating* expense or to charge them to capital account returnable through depletion?

3. It is true, is it not, that under the Revenue Act of 1918 it made absolutely no difference whatever whether intangible drilling and development costs were described as *operating* expenses or *development* expenses?

4. It is true, is it not, that the phrase, "net income from the property," *first* originated in Section 234 (a) (9) of the Revenue Act of 1921?

5. It is true, is it not, that shortly after the enactment of the Revenue Act of 1921 the Bureau gave consideration to the meaning of "net income from the property" and reached the conclusion that it should be computed without regard to development costs and without regard to whether a particular taxpayer elected to deduct them in computing taxable income or to charge them to capital account? (See G. C. M. 2315, C. B. VI-2, p. 21.)

6. It is true, is it not, that in promulgating Art. 223 of Regs. 62 (under the 1921 Act) the Bureau changed its description of intangible drilling costs to *development* expense, as distinguished from *operating* expense?

7. It is true, is it not, that in Article 201 (h) of Regs. 62 the term "net income from the property" was defined as "the gross income from the sale of all mineral products and any other income incidental to the *operation* of the property for the production of the mineral products, less *operating* expenses, including depreciation on equipment, and taxes, but excluding any allowance for depletion"?

8. And it is true, is it not, that *development* costs, as defined in Art. 223 of Regs. 62, were not regarded by the Bureau as *operating* expenses within the meaning of Art. 201 (h)?

9. It is true, is it not, that when the Revenue Bill of 1924 was pending before Congress, A. W. Gregg, then Special Assistant to the Secretary of the Treasury, appeared and urged that the *limitation* on the discovery depletion allowance be reduced from 100% of the "*operating* profit from the property upon which the discovery is made" to 50% of the "operating profit"?

10. And it is true, is it not, that the report of the Senate Committee on Finance on the Revenue Bill of 1924 referred to the limitation on discovery depletion, that is, "net income from the property," as a percentage of "operating profit"?

11. It is true, is it not, that Art. 201 (h) of Regs. 65, under the 1924 Act, did not require the deduction of intangible development costs in arriving at "net income from the property"?

12. And it is true, is it not, that the Bureau, in administering the 1924 Act, as well as the 1921 Act, never contended that intangible drilling costs should be deducted in determining "net income from the property"?

13. It is true, is it not, that Judge Foster of the Fifth Circuit is utterly in error, in his opinion in the *F. H. E. Oil Company* case, when he says that under the Revenue Act of 1924 the limitation of 50% of the "net income from the property" was a limitation on *cost* depletion?

14. Is it not true that the limitation based on "net income from the property" has never, under any revenue law, been a limitation on *cost* depletion?

15. Is it not true that "net income from the property" was used, in the Revenue Acts of 1921 and 1924, as a limitation on *discovery* depletion and, in the 1926 and subsequent acts, as a limitation on *percentage* depletion?

16. Is it not true, as Judge Foster has said, that the Revenue Act of 1926 made a "radical change" as to the basis for computing depletion, when discovery depletion was abandoned and percentage depletion substituted therefor?

17. But is it not also true, that even in the face of this radical change, Congress saw fit to make no change in the *limiting* formula—that the same formula that operated to limit *discovery* depletion under the 1921 and 1924 Acts, was *retained* as a limitation on *percentage* depletion under the 1926 Act?

18. What evidence is there that Congress, in using the term, "net income from the property," in the 1926 or 1928 Acts, intended that phrase to be given a different meaning from that which the Treasury had given to identical language in the 1921 and 1924 Acts?

19. If, as you contend, the change in 1926 from discovery to percentage depletion required a different meaning to be given to the phrase, "net income from

the property," why is it that no such change was made in promulgating Regulations 69 (under the 1926 Act)? Why is it that Regs. 69 have never been amended?

20. Is it not true that many taxpayers, in connection with their income tax returns for the year 1925, made an election to deduct intangible drilling costs in determining taxable net income?

21. Is it not true that such election for 1925 requires such taxpayers to continue to deduct intangible development costs in "all subsequent years"—even down to the present time?

22. Is it not true that the *first* Treasury Regulation attempting to require the deduction of intangible development costs in arriving at "net income from the property" was Art. 221 (i) of Regs. 74?

23. Is it not true that this was not promulgated until February 15, 1929, and long after many taxpayers had made their election for 1925?

24. Is it not true that the Treasury has never, at any time since February 15, 1929, offered to release taxpayers from the binding effect—for all subsequent years—of the election made in connection with their returns for 1925?

25. Is it not true that if the Treasury had given notice of its attempt to change the definition of "net income from the property" *prior* to the exercise of

the option for the year 1925, many taxpayers might have elected to capitalize tangible development costs?

26. When the Treasury is still holding taxpayers to the effect of an election made for the year 1925, is it consonant with fair play to attempt to change the administrative construction which had been in effect for many years, which had been specifically brought to the attention of, and approved by, Congress in 1924, and upon the faith of which the taxpayer's election was made?

Conclusion.

The judgments of the Board of Tax Appeals and of the Court below should be affirmed.

Respectfully submitted,

JOSEPH D. BRADY,
Counsel for Respondent.

458 South Spring Street,
Los Angeles, California.

September 27, 1939.

APPENDIX.

G. C. M. 2315, C. B. VI-2, page 21:

An opinion is requested as to whether development expenditures made in connection with oil or gas wells should be deducted from the gross income of a discovery property in determining the net income from the property within the meaning of section 234 (a) 9 of the Revenue Act of 1921 where the taxpayer corporation, pursuant to article 223 of Regulations 62, elected to deduct such expenditures from its gross income in computing net income subject to Federal income or profits taxes.

Shortly after the enactment of the Revenue Act of 1921, the construction of the proviso inserted in section 234 (a) 9 of the Act that the "depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made" was given consideration by the Bureau, and the decision was reached that the "net income from the property" referred to in the proviso should be computed without regard to development expenditures, that is, that development expenditures should not be treated as a deduction in computing the "net income from the property" regardless of whether the taxpayer corporation under article 223 of Regulations 62 elected to treat such expenditures as operating expenses deductible in computing taxable income or to charge them to capital returnable through depletion. In view of the decision made at that time, the fact that it has been uniformly followed in closing a great number of cases, and the desirability of a consistent

administration of the provision in question, the conclusion is reached that in applying the limitation on discovery depletion in the case of oil and gas wells provided for in section 234 (a) 9 of the Revenue Act of 1921, the gross income from a discovery property should not be reduced by development expenditures in the computation of the "net income from the property," which amount measures the maximum depletion allowance based on discovery which can be allowed in respect to such property. A like construction should be followed in applying the provisions of section 214 (a) 10 of the Revenue Act of 1921 and the provisions of section 204 (c) of the Revenue Act of 1924. The latter section restricts a depletion allowance based on discovery value to "50 per centum of the net income (computed without allowance for depletion) from the property upon which the discovery was made."

The construction herein adopted relative to discovery depletion in the case of oil and gas wells under the 1921 and 1924 Acts should be confined to those Acts. Under section 204 (c) 2 of the Revenue Act of 1926, provision is made that in the case of oil and gas wells the allowance for depletion based upon the gross income from the property "shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property." The term "net income" as used in that section should be taken to mean the net income defined in sections 212 and 232 of the Act. Accordingly, if a taxpayer elects to treat development expenditures as ordinary and necessary business ex-

penses deductible under section 214 (a) 1 or 234 (a) 1 in computing taxable net income, such expenditures must be deducted in determining the net income from the property, which amount is used as a limitation in the computation of the depletion allowance based on income.

A. W. GREGG,
General Counsel, Bureau of Internal Revenue.

S. Rep. No. 960, 70th Cong., First Sess., p. 20:

"Sec. 23(k) and (l) Depreciation and Depletion—Life Estates and Trusts—The House *bill makes no change in existing law* with respect to these deductions. The Committee proposes to amend and clarify the law governing the manner in which the deductions shall be apportioned as between life tenant and remainderman or trustee and beneficiary. There is uncertainty and considerable hardship *in these two classes of cases* under the existing law.

In the case of life tenant and remainderman the bill provides that deduction for depreciation shall be computed as if the life tenant were the absolute owner of the property * * * In the case of property held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustees in accordance with the pertinent provisions of the will. * * * The bill contains similar provisions as to deductions for depletion."

H. Rep. No. 1882, 70th Cong., First Sess., p. 11:

"Amendment No. 30: Under existing law difficulty has been experienced in determining and allowing the deduction for depreciation in cases where property is held by one person for life with remainder to another person; and the deduction in the case of property held in trust, is allowable only to the trustee. The Senate amendment provides that a life tenant, for the purpose of this deduction shall be considered as the absolute owner; * * * in the case of property held in trust the allowable deduction is to be apportioned between the income beneficiary and the trustee in accordance with the pertinent provisions of the will. * * * The bill contains similar provisions as to deduction for depletion. The Senate amendment provides for an equitable apportionment in the deduction of this case. And the House recedes.

"Amendments Nos. 31 and 32. The purpose and effect of these amendments, which relate to the deduction for depletion in the case of property held by one person and remainder to another person, and in the case of property held in trust, is similar in effect to amendment No. 30. And the House recedes."